

# Fiscal Research Program

## REFLECTIONS ON PRIVATIZATION

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## FOREWORD

The concept of the private provision of services is not new at the state and local level in the United States. As Dr. Steve Hanke points out, the provision of services and products by government is the more recent phenomena. Since the mid-1970s and early 1980s, there has been an increase in efforts to privatize government services at both levels, particularly municipal services. However, in the wake of the fiscal crisis experienced by many states during the recession of the early 1990s, renewed interest has emerged in considering privatization options for state programs and services to achieve greater efficiency and effectiveness as well as a means of downsizing the level of public employment and simplifying the general government structure. Dr. Hanke's paper on "Reflections on Privatization" provides an excellent grounding in the economic and policy fundamentals of privatization. His insights will be instructive and useful to practitioners and elected policy makers as they debate the advantages and disadvantages of converting current government managed services to private management and/or ownership. Dr. Hanke's efforts to frame the appropriate questions to be addressed in the privatization debate are particularly valuable. Only if the right questions are considered will wise decisions be made on privatization.

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## REFLECTIONS ON PRIVATIZATION

*Dr. Steve Hanke*

It is perhaps difficult to realize today how limited the functions of government were through most of American history. Until World War I, the Federal government exercised only a narrow range of functions and imposed essentially no taxes other than the tariff. Most states assumed only a few responsibilities. Local government had a wider range of activities, but not many by present standards.

Gradually, government participation in economic and business activities increased. Franchises granted exclusive privileges to a few businesses, notably public utilities. Regulation of some private operations increased. For various reasons, municipal-reform movements developed in some cities in the late nineteenth century and after. In some cases these movements led to “municipalization” of functions that had been performed privately. By 1930, municipalities were performing many functions that were by no means inherently governmental, yet the number of municipal- and state-performed business activities was only a small percentage of the total economy. The Federal government ran the post office but provided few other services except national defense.

Since the 1930s, however, governments assumed a greater role in the economic affairs of most countries. There has been more emphasis on macroeconomic planning and management. In addition, public-sector budgets have grown in absolute terms and also in relation to the size of private-sector activity. This growth has been the result of rapid increases in welfare programs, military expenditures, and a vast increase in the range and scale of so-called public infrastructure and services. Many countries have also increased the scope of government by embracing the concept of an entrepreneurial state—one that is allegedly the engine of growth and development as well as one that attempts to achieve growth by either operating nationalized industries or intervening heavily in the operation of private firms (state capitalism). Of course, some countries have adopted or—more often—had socialist and communist economic systems imposed on them.

This trend toward more government involvement in economic affairs was accompanied by a literature dominated by arguments that, in one way or another, attempt to rationalize public-

sector activity. This imbalance has been reflected in popular dictionaries and specialized reference works. For example, before 1983, Webster's New Collegiate Dictionary contained an entry for nationalization but not for privatization. The Encyclopedia of the Social Sciences also omits privatization and includes an entry for nationalization.

Since about 1980, the trend toward more government spending, ownership, and intervention has been seriously questioned. This has sparked new debate about the merits of private versus public ownership. Privatization, which is the transfer of assets or service functions from public to private ownership or control, has emerged as the focal point of the debate. Consequently, the word privatize has been recognized, and the imbalance between nationalization and privatization has begun to be redressed. For example, privatize appeared in Webster's Ninth New Collegiate Dictionary in 1983, and the word also was in The New Palgrave—a four-volume economics dictionary published by London's Macmillan Press Ltd. in 1987. More importantly, many privatizations have actually occurred, most notably in the former communist countries.

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The economic theory that underpins privatization rests on a corpus of analysis which deals with the economics of property rights. This literature shows that alternative forms of property ownership give rise to different economic incentives and, subsequently, different economic results. Private enterprises are owned by individuals who are free, within the limits of the law, to use and exchange their private property rights in these assets. These rights give individual owners "residual claim" on the assets of private enterprise. When these assets are used to produce goods and services that consumers demand at costs lower than market prices, profits are generated, and the income and wealth of property owners are increased. Alternatively, if production costs exceed market prices, losses are incurred, and the value of a firm, along with the income and wealth of the owners of the firm's assets, is diminished. Stated differently, owners of private firms gain from efficient management and bear the costs of inefficient management. Private owners ultimately face the "bottom line," which measures profits (or losses) that owners claim.

Incentives created by private property right—by the link between outcomes from using private assets and the income and wealth of the owners—have profound consequences. Private owners face incentives that make it desirable to monitor the behavior of managers and employees in their enterprises, so that consumer demands are supplied in a cost-effective way over time. As a result of being subjected to this kind of monitoring, private managers are encouraged not to shirk their responsibilities or to engage in behavior that is inconsistent with maximizing the present value of the enterprise (the owners' wealth). In other words, private property rights create incentives that promote efficient performance.

The market for shares acts as a court of last resort to reinforce the incentives created by private property. The anticipated effects of current actions are capitalized into the present value of shares. If incumbent managements' actions are inappropriate, share prices will fall and the returns from the purchase of shares for the purpose of a corporate takeover, which is designed to replace the current management, will increase. In consequence, the threat of corporate takeovers is a disciplining force on incumbent managements. The combination of owners monitoring managers and the market for corporate control acts to generate efficient performances by private firms.

By way of contrast, public enterprises are not owned by individuals who have residual claims on the assets of these organizations. The nominal owners of public enterprises, the taxpayer-owners, cannot buy or sell these assets, so they do not have strong incentives to monitor the behavior of public managers and employees. Taxpayer-owners could capture some benefits from increased efficiency of public enterprises through tax reductions. If realized, however, these incremental benefits would be spread over many taxpayers; an individual's benefits would be small. And an individual's costs of obtaining these benefits—acquiring information, monitoring public employees, and organizing an effective political force to modify the behavior of public managers and employees' would be high. The consequences of public ownership are thus predictable. Public managers and employees allocate resources (assets) that do not belong to them. Hence, they do not bear the costs of their decisions; nor do they gain from efficient behavior. Since the nominal owners of public enterprises, the taxpayers, do not have strong incentives to monitor the performance of public employees, the costs of shirking are relatively

low. Public employees, therefore, commonly seek job-related prerequisites, which increase production costs and divert attention from serving consumer demands.

Public and private enterprises are similar in that they both must plan. Public planning is, however, fundamentally different from private planning. Public plans are developed by public managers and employees who neither bear the costs of their mistakes nor legally capture benefits generated by foresight. Moreover, public plans are developed by people who do not have to answer to any owners. As long as the planning rules and procedures are followed, a public plan is considered a good plan. Private planning is quite a different story. Private plans attempt to anticipate consumer demands and production costs correctly, because the present value of the private enterprise depends on correct anticipation of demands and costs. Needless to say, private planners ultimately have to answer to the owners of private enterprises, who keep a watchful eye on the value of the enterprises that they own.

Comparative cost analysis of private versus public provision of goods and services give support to the conclusion that private firms are more cost-effective than public firms. Considerable evidence suggest that the public cost incurred in providing a given quantity and quality of output is about twice as great as private provision. This result occurs with such frequency that it has given rise to a rule-of-thumb: the 'bureaucratic rule of two.'

Broader measures also confirm the conclusions reached through economic analysis. When compared to their private counterparts, sales per employee are lower for nationalized enterprises. Adjusted profits per employee are lower. Physical production per employee is lower. Taxes paid per employee are lower. Per dollar of sales, operating expenses plus wages are higher. Sales per dollar investment are lower. Profits per dollar of total assets are lower. Sales per employee grow at a slower rate. And, with the exception of nationalized oil companies, nationalized enterprises typically generate accounting losses.

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Economic analysis and empirical evidence support the notion that economic performance will be improved through privatization. However, it should be stressed that privatization's

potential to accomplish this objective is greatest when newly privatized entities encounter an environment in which (1) product markets are competitive, (2) the entities are subject to the takeover threat, and (3) the entities are allowed to go bankrupt.

In the context of competitiveness, so-called monopolies, where the average costs of production decline throughout the relevant range of consumer demand, merit special mention because entities that are candidates for privatization often have natural monopoly characteristics. That competitive results can be obtained in then the natural monopoly context was articulated by Edwin Chadwick in 1859. The essential point he made was that competition in the natural monopoly context should focus on the right to serve an entire service area, rather than to serve individual consumers. Chadwick argued that an exclusive franchise or concession to supply an entire service area should be established and that private firms should be required to compete for the right to serve the franchise.

The keys to Chadwick's system are the bidding procedure for the contract to serve the franchise and the monitoring of the contract. To obtain the desired result, the franchise must be awarded to the firm that agrees to serve the market with the lowest prices for the output specified in a contract. The public authority responsible for establishing the franchise would act as a bargaining agent for consumers in the franchise area. The public authority would seek to award the franchise to the private firm that agrees to supply a given quality and quantity of service over the franchise's life at the lowest price. The successful bidder would have a contract for all consumers in the franchise area. This contract would be monitored by the public authority.

Chadwick's franchise system solves the competitiveness problem associated with natural monopolies, and at the same time, puts in place the incentives that tend to generate a cost-effective provision of goods and services. This system of franchises is widely used in France, with desired economic results.

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Economic theory and empirical evidence suggest that the choice between public and private supply of goods and services should be an easy one to make. Indeed, we should rely on

the private sector for the provision of goods and services.

However, some argue that the government must supply various goods and services because the poor cannot afford the prices that private suppliers would have to charge to recover costs. This assertion is incorrect. Whether the poor can or cannot afford privately supplied goods and services should not bear on the choice between private and public supply. The decision about the appropriate means of supply should be based on which supply alternative, private or public, can produce a given quantity and quality of goods and services at the lowest cost.

If private enterprise can supply a given quantity of goods and services by utilizing fewer resources than public enterprise, then private enterprise should be employed. If the broad polity deems that private finance- which operates through consumer sovereignty and private charity - does not allow the poor to purchase adequate quantities and qualities of goods and services from a cost-effective private enterprise, then the polity must choose the method and level of public finance to be used to assist the poor. This choice between private and public finance is separable from the choice between private and public supply. The separability of supply and finance allows us to properly concentrate on the issues surrounding the choice between private and public supply, without considering the method to be used to finance the desired supply.

In order to improve the manner in which goods and services are supplied, the first step should be to privatize public enterprises. Then—to the extent that the polity desires to alter the level or mix of goods and services produced by private enterprises entities—the merits of modifying the manner in which goods and services are financed should be considered.

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If “rolling back the frontiers of the state” was the policy mantra of the 1980s, then the creed of the 1990s is to roll them downwards. This is true “in spades” in the United States. In consequence, state and local governments will have to confront the choice between the private and public supply of goods and services much more frequently and seriously than they have in the past.

I conjecture that, to stay competitive, many more state and local governments will choose



the private supply route. In addition to the arguments favoring private provision, which have been outlined above, the fiscal arithmetic favors the private supply of goods and services. Indeed, if the public supply route is taken, state and local governments will have to increase spending. And spending increases can be financed by either increasing taxes or government borrowing. But, both of these financing options are unattractive. Increased taxes are a hard sell, even for the most clever politicians, and increased borrowings are frowned on by bond rating agencies.

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The choice between public and private supply will, therefore, be an easy one to make. To stay competitive, the challenge will be to actually implement privatization and the private provision of goods and services at the state and local levels. And this challenge is a good deal more formidable than most economists realize. Indeed, a recent World Bank study, Bureaucrats in Business: the Economics and Politics of Government Ownership (1995), shows that, despite the significant benefits of privatization, its progress has been slow outside of Eastern Europe and the Former Soviet Union. Alas, as one of the study's authors, Mary Shirley, recently said, "The so-called decade of divestiture has produced more hot air than hot prospects."

In the cases in which the challenge has been overcome, two necessary conditions have been met. A political leader has had a private-supply vision. The "vision thing" is vital because political leaders must sell the merits of privatization and private-supply to the polity. After all, it is only with the polity's backing that a political leader can proceed with a plausible, credible privatization program. In addition to a leader with vision, the leader has had command over a technical team that can deliver on the leader's vision. When these two ingredients are in the stew, privatization and the private provision of goods and services have worked with textbook precision, and the desired results have been obtained.

Competition among the states promises to motivate politicians, so that they see to it that the necessary conditions required to meet the privatization-implementation challenge are satisfied. In consequence, I am optimistic that privatization will produce much more than hot air in the coming years.

## Steve H. Hanke

Dr. Steve Hanke is a Professor of Applied Economics at The Johns Hopkins University in Baltimore. In addition to extensive writing and research on privatization, he has been government advisory on the identification and implementation of privatization policies.

Dr. Hanke's books include: The Anatomy of Hong Kong's Currency Board System (1995), Alternative Monetary Regimes for Jamaica (1995), Currency Boards for Developing Countries (1994), Russian Currency and Finance (1993), Capital Markets and Development (1991), Prospects for Privatization (1987), and Privatization and Development (1987).

In addition to his government advisory work on privatization, Dr. Hanke advises governments on currency reform and capital market development. At present, he is Adviser to the Minister of Economy and Public Works and Services in Argentina, Adviser to the Fondo de Inversiones de Venezuela in Caracas, Adviser to the President of Kazakhstan in Alma Alta, and State Counselor on Monetary and Financial Issues in Lithuania. In the past, Dr. Hanke served as a Senior Economist on President Reagan's Council of Economic Advisers (1981 - 1982) and as Personal Economic Adviser to the Vice President of Yugoslavia (1990 - June 1991).

Dr. Hanke is a member of the Steering Committee of the G-7 Council in Washington, D.C., a Fellow at The World Economic Forum in Geneva, and a Member of the Board of Governors at the Philadelphia Stock Exchange.

As a complement to his extensive commercial activities, Dr. Hanke writes a regular column for Forbes magazine.